C5800-11
12/17/82

Economics Department

McGraw-Hill Publications Company
1221 Avenue of the Americas
New York, New York 10020

November, 1982

U.S. BUSINESS OUTLOOK, SHORT-TERM

The recovery has been put on hold.

Gross national product (GNP) adjusted for inflation didn't budge at all in the third quarter, and still sits about 2% below the year-ago level. What's more, some of the weakness that showed up last summer could easily carry over into the fourth quarter of this year and into the first half of next year.

Further delay in a readily perceptible recovery could then force significant policy change on the Administration. It could also force some shift in the Federal Reserve Board's monetary stance. Or it could force Congress to "do something" about the federal budget deficit.

At this point, however, what eventually happens on the policy front is conjecture. What happened in the third quarter is more concrete. And in terms of growth, what happened in the third quarter was a big goose egg--not the golden variety promised by the Reagan Administration, but one that suggests the economy could be in for some more trouble.

Reading the Third-Quarter Tea Leaves

If the economy in the third quarter has any message for the next few quarters, it is this: Consumers are scared.

For despite significant (highly-publicized) drops in interest rates and surges in stock prices, and despite an annualized 10% jump in

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after-tax income this summer thanks to the July tax cut, consumers nonetheless hunkered down. Instead of flocking to stores and showrooms, they saved more and borrowed less. While they bought necessities, they put off big-ticket purchases to some future sunny day. Thus consumption adjusted for inflation inched ahead by only 1% at an annual rate in the July-September period. In other words, the booster needed to fuel the recovery fizzled.

Yet judging from income, savings, and debt position alone (see Chart I), consumers should be doing a lot more to spur the economy. What's missing from this equation, however, and what is apparently overwhelming everything else in it, is unemployment.

In September the unemployment rate went past 10%. Now it is taking aim at 11%. That means the economy is too weak to generate new jobs, which in turn points to sluggish personal income growth in the near future. Perhaps more important, with people increasingly sensitized to the possibility of losing work, it means much of whatever income gains are made will likely go into savings.

The third quarter's consumer tea leaf, therefore, points to slow growth in real consumption in the next half year or so, with a blip here and there due to rebate-induced pickups in auto sales.

Consumer purchases, nonetheless, are still expected to make a positive (if disappointing) contribution to the economy next year.

On the other hand, the big negative of the third quarter--net exports (down 73% annualized)--is expected to continue to deteriorate on average next year as the strong dollar casts a pall over exports and encourages imports. True, the dollar may begin to lose ground due to the drop in interest rates and bigger merchandise trade deficits. But

Chart I. Consumption Drags as People Save More, Borrow Less

	Disposable Personal Income (Billion 1972$)	Savings As % of Disposable Personal Income	Consumer Debt As % of Personal Income	Consumption (Billion 1972$)
1976	907.4	6.9	12.94	823.1
1977	939.5	5.9	13.78	864.3
1978	981.5	6.1	14.46	903.2
1979	1011.5	5.9	14.80	927.6
1980	1018.0	5.8	13.46	930.5
1981	1043.1	6.4	13.21	947.6
1982e	1057.0	6.9	12.90	957.0
1981*				
IQ	1035.0	5.4	13.29	951.1
IIQ	1036.6	6.1	13.30	944.6
IIIQ	1048.8	6.5	13.13	951.4
IVQ	1051.9	7.5	13.11	943.4
1982*				
IQ	1046.9	6.6	13.06	949.1
IIQ	1054.8	6.7	12.98	955.0
IIIQ	1060.9	7.0	12.83	957.7
% Change**				
1976-82	16.5	0.0	-0.04	16.3
1976-1982:III	16.9	0.1	-0.11	16.4
1981:III-1982:III	1.2	0.5	-0.30	0.7
1982:II-1982:III	0.6	0.3	-0.15	0.3

*Quarterly data at annual rate.
**Percentage point change for saving rate and consumer debt/income.
eEstimate

changes in a country's exchange rate take awhile to affect exports and imports as buyers and sellers adjust to new prices.

The net export account will also suffer due to a weak world economy. Most developed countries are experiencing their own recessions while less developed countries may cut imports to reduce a debt that has made international bankers skittish.[1]

Capital investment will also be a drag on economic growth for much of next year. Companies' sales have been far too weak to spur a need for any new capacity; profits are only just starting to stage a comeback from low levels; and interest rates, though falling since mid-year, remain high. In an attempt to cope with this adverse sales and financial environment, companies are chopping 1983 capital budgets. After adjusting for inflation, McGraw-Hill's fall capital spending survey shows a severe 8.5% cutback next year in new plant and equipment spending.

While crimping nonresidential investment, continued high interest rates will also put a damper on residential investment. Though mortgage rates have fallen a couple of points this year, Chart II shows that they are still extraordinarily high by historical standards. Not surprisingly, then, housing starts are expected to remain extraordinarily low. Looking at things more optimistically, the mortgage rate drop will enable housing to stage a rebound, from a 36-year low of one million in 1982 to 1.3-1.4 million in 1983. That would make housing the most rapidly growing sector of GNP next year, although activity will remain far below the levels of the late 1970s.

Federal as well as state and local government spending is forecast to rise a bit in real terms next year due to defense and also because of

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[1] Net exports may rise in 1982's fourth quarter due to technical factors. For example, a sharp rise in August imports look statistically suspicious, and may get reversed in later months.

Chart II. Mortgage Rates Must Fall Much More for Housing to Boom

	Mortgage Rate (%)*	Thousands (SAAR) Housing Starts	Thousands (SAAR) New House Sales
1976	9.0	1538	646
1977	9.0	1987	819
1978	9.7	2020	818
1979	11.3	1745	706
1980	14.0	1292	545
1981	16.7	1100	429
1981			
IQ	15.4	1399	510
IIQ	16.2	1173	444
IIIQ	17.3	962	358
IVQ	17.9	865	402
1982			
IQ	17.5	920	385
IIQ	17.3	952	366
IIIQ	16.8	1112	398

SAAR - Seasonally Adjusted Annual Rate.
*Rate includes "points" amortized over ten years.

a little pump priming. But that gets into guessing about policy, which in the post-election haze seems far from clear.

Before possible policy shifts are outlined, the third quarter's individual tea leaves should be arranged in a pattern to see what they say about the near future. That pattern is one of persistent weakness in net exports and business investment, offset by modest gains in consumer spending, a healthy advance for housing from depressed levels, and a small rise in government expenditures (assuming a limited jobs program). Adding it all up yields less than 1% (annual rate) economic growth in 1982's fourth quarter, and only about 2% growth in the first half of 1983. Beyond that, what happens will depend on whether the federal government comes to grips with the ever-mushrooming budget deficit, and

whether the Federal Reserve Board can successfully keep interest rates down without igniting fears of rapid future inflation.

The Budget Behemoth May Block Road to Recovery

In order for recovery to take hold it is imperative that interest rates stay down. In order for the economy to achieve sustained expansion beyond next year, it is highly desirable that rates fall further.

For its part, the Federal Reserve has signaled it will keep at least one eye on interest rates, allowing them to ease even if it means money growing above target. Aiding the central bank in attaining this goal will be softening business demand for funds due to cutbacks in capital and inventory investment.

Such cutbacks have already weakened companies' demand for funds, and in conjunction with rapid money and bank reserve growth this has pushed rates down considerably since July (see Chart III). In fact, some

Chart III. Rates Drop As Money Surges and Funds Demand Sinks

1982	Net Change in Bank Loans to Business ($ Billions)	Change in Commerical Paper ($ Billions)	Money Supply (M1) % Change	--Interest Rate (%)-- 3-Month Treasury Bill	Corporate Bonds
Jan.	46.64	-2.4	23.1	12.4	15.2
Feb.	58.09	-4.8	-3.4	13.8	15.3
March	9.40	19.2	2.7	12.5	14.6
April	54.30	61.2	11.5	12.8	14.5
May	40.56	51.6	-2.4	12.1	14.3
June	40.80	31.2	-0.3	12.1	14.8
July	9.59	21.6	-0.3	11.9	14.6
Aug.	4.86	-42.0	10.9	9.0	13.7
Sept.	41.52	-40.2	14.9	8.2	12.9
Oct.	24.78	-46.0	22.3	7.8	12.1

short-term rates adjusted for inflation are back within historical experience after having shot way beyond the normal range.

There persists, however, a big problem--the corporate bond rate, which is down but still very high. And it is the bond rate that will determine whether companies can restructure shaky balance sheets by converting some of their excessive short-term debt into long-term.

Why the corporate bond rate is hanging way up there may have to do with another key area of policy--the federal budget, or rather the federal budget deficit.

As the money supply and stock prices shot up and interest rates slid down during the pre-election summer, most economic policy attention was focused on the Fed. Had they really aggressively eased monetary policy? Were they now targeting interest rates? Or were the jumps in M1 merely due to maturing All-Savers? When the All-Savers money comes out of checking accounts and goes into new investments, will the Fed go back to M1 targeting?

Outside of the spotlight's glare on monetary policy, however, fiscal policy continued to deteriorate. Just a few months ago, federal deficit estimates were in the $150 billion range for 1983. Now they're closer to $200 billion--about 6% of GNP, the highest percentage in post-World War II history.

With the election over, some government officials have begun to focus national attention on this unprecedented sea of red ink. The Administration's chief economist, the Office of Management and Budget, and members of the Federal Reserve are all pointing to huge deficits as a cause of high interest rates and economic stagnation. Will the politicians take up the gauntlet?

The top politician, President Reagan, has vowed to defend against any and all attacks on the Pentagon budget. Congress, meanwhile, is moving ahead to cut a few billion from military outlays next year, targeting in particular the Pershing II and MX missiles. Congressional success would certainly help pare the 1983 deficit, yet even a smashing Congressional victory would not make much of a dent in the deficit--perhaps $11 billion.

The other sacred mastodon in the federal budget is Social Security, where mounting trust fund deficits are causing lots of deeply concerned looks. But there is no popular way to plug the hole--either payroll taxes have to be hiked or benefit increases scaled back. Thus politicians will handle the issue very gingerly, so gingerly in fact that they may do nothing at all.

The forecast at the end of this report assumes some tentative steps are taken to resolve the Social Security crisis and to curb the Pentagon--steps, however, that may not add up to much forward progress for several years. Consequently, Congressional action will probably not be sufficient to quell financial market fears of either higher inflation through monetization of the deficit or higher interest rates due to huge Treasury borrowings.

Thus interest rates are expected to bottom out in the first half of next year at still-high levels. They will not prevent modest economic growth thereafter, driven by housing and personal consumption. But it will act as a restraint on the economy into 1984.

One government measure that does seem to have some chance of getting enacted in the near term is a rise in the gasoline tax, the proceeds from which would finance public construction jobs. It's

expected some such measure will be adopted, but that it will be too small ($5-$6 billion) to have much impact on the overall economy.

Another proposal receiving attention is President Reagan's idea of advancing the 10% personal tax cut from July 1 to January 1. Judging from the rising chorus of warnings about big budget deficits, it seems the President's deficit-widening proposal will go down to defeat. Opponents could also point to the failure of the 1982 tax cut to spark a recovery. In fact, sentiment could mount to eliminate the 1982 tax cut altogether--a move that in one fell swoop would shrink the deficit by $30-$35 billion. The forecast assumes the President could overcome any move to abolish the tax cut, but that he is unable to advance the cut to January 1.

By mid-1983, the unemployment rate should have peaked and interest rates should be somewhat lower than at present. Hence the 1983 tax cut may play to a more receptive audience than did the 1982 cut. Consumer spending, therefore, is expected to bounce up. Along with continued increases in residential investment, a little inventory building, and an end to capital spending declines, consumption is then forecast to lift the economy in the second half of 1983.

But because of weakness in the first half of next year, and less than total success in the second half, the economy in 1983 as a whole is forecast to advance only 2%.

Taking a longer view, 2% growth in 1983 would put average annual growth in 1979-83 at 0.5%--hardly enough to reduce the unemployment rate or to improve the average person's standard of living. If economic stagnation persists beyond 1983, therefore, it could lead to major policy changes in Washington. With the budget deficit starting to look

unmanageable, high interest rates are starting to look like a permanent feature of the economy, the implication being that further stagnation in the Presidential election year of 1984 is certainly a possibility. Hence the next time Americans go to the polls could mark a watershed in U.S. economic policy.

Summary

The consumer, mindful of the shaky employment situation, has yet to take up the role of recession buster. And with unemployment likely to stay above 10% for quite some time, the willingness of consumers to spend big has been cast into doubt.

Meanwhile, a strong dollar is depressing exports and slumping sales are causing companies to slash capital investment. In the private sector, only housing is making significant gains, but from an extremely low level.

The immediate prospect, then, is for the economy to limp through the next couple of quarters. But at least a little growth should occur (fueled by housing and defense spending), which means the unemployment rate should top out this winter. Interest rates should also continue to drift down. Thus when the next tax cut comes around on July 1, 1983, consumers could be in more of a spending mood than they were in 1982.

With housing investment continuing upward, with inventory rundowns completed, and with capital investment declines at an end, the economy is then forecast to pick up in the second half of 1983.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

National Product Accounts	Actual 3Q	Forecast 1982 4Q	Forecast 1983 1Q	Forecast 1983 2Q	Forecast 1983 3Q	Forecast 1983 4Q	Annual 1981	Annual 1982	Annual 1983
Gross National Product	3080.7	3128	3183	3234	3303	3392	2937.7	3062.4	3278.0
Consumer Spending	1987.5	2020	2052	2086	2132	2180	1843.2	1968.7	2112.5
Durables	240.1	245	247	250	260	268	234.6	240.9	256.3
Nondurables	767.9	772	778	786	797	812	734.5	761.0	793.3
Services	979.5	1003	1027	1050	1075	1100	874.1	966.8	1063.0
Fixed Investment	438.4	437	445	453	465	481	451.1	443.4	461.0
Nonresidential	341.2	332	332	332	336	347	346.1	345.6	336.8
Structures	139.1	136	135	134	134	135	129.7	140.0	134.5
Producers Durable Equipment	202.1	196	197	198	202	212	216.4	205.6	202.3
Residential	97.2	104	113	121	129	134	104.9	97.5	124.3
Inventory Change	2.9	-6	-1	0	3	5	20.5	-13.7	1.8
Government Purchases	649.2	667	680	691	703	723	596.9	644.3	699.3
Federal	256.4	269	277	281	285	295	228.9	254.9	284.5
Defense	182.2	191	196	200	204	212	153.7	178.9	203.0
Nondefense	74.3	78	78	79	79	83	75.2	76.0	80.3
State & Local	392.7	398	405	412	420	428	368.0	389.4	416.3
Net Exports	2.7	12	7	4	0	3	26.1	20.2	3.5
Real GNP (1972 Dollars)	1478.4	1481.0	1487.7	1496.0	1510.5	1531.0	1502.6	1477.1	1506.3
(% change at annual rate)	0.0	0.7	1.8	2.3	3.9	5.5	1.9	-1.7	2.0
Implicit Price Deflator	208.38	211.21	213.96	216.17	218.67	221.56	195.51	207.31	217.59
(% change at annual rate)	4.7	5.5	5.3	4.2	4.7	5.4	9.4	6.0	5.0
Key Economic Indicators & Assumptions									
Unemployment Rate (%)	9.9	10.6	10.8	10.6	10.3	9.7	7.6	9.7	10.4
Housing Starts (thousands of units)	1112	1157	1250	1325	1370	1400	1100	1035	1336
Consumer Price Index (% change at annual rate)	7.6	3.8	4.4	4.9	5.3	6.3	8.9	6.2	5.0
90-Day Treasury Bill Rate (%)	9.7	7.8	7.5	7.5	8.0	8.5	14.1	10.7	7.9
Corporate Bond Yield (%)	13.8	11.5	10.5	10.5	10.8	11.5	14.2	13.7	10.8
Personal Income ($ Billions, SAAR)	2596.0	2633	2666	2708	2762	2812	2415.8	2573.1	2737.0
Disposable Personal Income ($ Billions, SAAR)	2201.7	2233	2266	2298	2370	2403	2029.1	2175.8	2334.3
Saving as % of Disposable Income	7.0	7.1	6.9	6.7	7.5	6.8	6.4	6.9	7.0

SAAR-Seasonally Adjusted Annual Rate

C5800-11 2/22/83

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Hope for a business rebound springs eternal.

After three years of economic stagnation punctuated by several false starts toward sustained expansion, a recovery scenario is again developing. The origin of the scenario goes back to last fall, when the severely depressed housing and auto industries both began to show signs of life. If housing and autos manage to stay on their feet, then their own strength plus the boost they give to other industries like steel, chemicals, textiles, appliances, and furniture will ensure a solid recovery.

More than solid, according to quite a few forecasters, who are convinced the 1983 economy will chalk up out-and-out vigorous growth of 5%-6%. That kind of a spurt would, in fact, be typical for a recovery. But typical recoveries do not start with long-term interest rates at 11%-12%, with inflation-adjusted long-term rates at 6%-7%, and with the prospects of $200 billion federal deficits stretching out beyond sight.

For the economy to grow 5% this year in the face of such obstacles would be extraordinary. These obstacles will probably not choke off growth altogether; but high interest rates, kept high by the deficit, will continue to undermine the strength that housing and autos traditionally exert in a recovery. Thus while cars and homes will be in

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the economy's vanguard, they will probably be leading with a slight limp, permitting the 1983 economy to advance by only about 2%.

Growth For Sure in the Short Term

In the final quarter of 1982 business went on another inventory-busting binge, just as it did in the first quarter of 1982, with automobiles accounting for much of the cutback in both cases (see Chart I). Whereupon, in both cases, auto makers decided to boost output

Chart I. Autos & Inventories Help Swing The Economy

	(Billions of 1972 Dollars, SAAR)				
	1982				Annual
Change in:	1Q	2Q	3Q	4Q	1982
Business Inventories	-15.6	-3.8	2.9	-17.9	-8.5
Auto Inventories	-7.0	2.7	4.8	-5.9	-1.3
Output of U.S. Autos	-3.9	9.1	3.0	-6.6	-4.1
Gross National Product	-19.4	7.7	2.7	-9.4	-27.1
Final Sales	0.8	-4.4	-4.9	11.5	-9.7

SAAR - Seasonally adjusted annual rate.

to replenish stocks. Last spring, this auto/inventory swing helped boost the economy 2.1% at an annual rate in the second quarter. The same kind of upward force is at work now. Due in large part to inventories, then, plus a boost from housing, inflation-adjusted gross national product is expected to advance at an annualized 4% pace in 1983's initial quarter.

But while essential for recovery, inventory restocking in and of itself cannot cause a recovery. Last year's example is still fresh and painful: Although the economy grew at annual rates of 2.1% in the second

quarter and 0.7% in the third on the strength of inventories, sales to end customers continued to slump, as shown in the "Final Sales" line of Chart I. Companies consequently again got stuck with excess stocks and in 1982's fourth quarter they again ran stocks down. In the process, they dragged down the economy by 1.9% (annual rate).

So inventory building alone does not a recovery make. In addition, people and businesses have to want finished products and they must have the wherewithal to buy these products. This second condition did not exist last spring after the first inventory turnaround; does it exist today?

Can the Consumer Contribute This Time Around?

The recovery fizzled last spring and summer because high interest rates: 1) slammed the door to a housing rebound, 2) sharply lifted the U.S. dollar and thereby sank U.S. exports, 3) throttled a sustained pickup in auto sales, and 4) worried consumers already unnerved by high and rising unemployment.

In short, neither Americans nor foreigners had the financial means to lift the U.S. into an expansionary orbit.

Today's story is that interest rates and the dollar are lower, though still high. Housing starts and auto sales are higher, though still low. The unemployment rate is higher, but employment has stopped falling. And the stock market is higher.

It's not a totally inspiring story, but it is cheerier than last year's for it does imply that people are more willing and better able to buy key big-ticket products made in the U.S. That positive mood will get bolstered, moreover, by the slide in petroleum prices, which means

Americans will be transferring fewer dollars to foreign oil producers. And when this year's tax cut rolls around July 1 (assuming Congress keeps it intact), further willingness to buy should become apparent.

It's true that last year's tax cut did not spur consumers to do much spending. But this year may prove different: Not only are interest rates and oil prices lower compared to last July 1 and not only are big layoffs dwindling, but consumer confidence should also be higher because savings are higher and debt burdens are lower (see Chart II). Consumers,

Chart II. Consumers Have Worked Into Financial Shape

	Personal Saving ($ Billions, SAAR)	Installment Debt (% of Personal Income)	Real Consumer Spending (% Change, Annual Rate)
1981: I	105.9	13.28%	4.4%
II	122.0	13.28	-2.7
III	134.4	13.13	2.9
IV	158.6	13.10	-3.3
1982: I	139.1	13.06	2.5
II	144.3	12.98	2.5
III	152.0	12.86	0.6
IV	128.9	12.81	5.0
Annual			
1980	106.2	14.04	0.3
1981	130.2	13.20	1.8
1982	141.1	12.93	1.0

SAAR - Seasonally adjusted annual rate.

that is, fought recession by tightening belts and by getting liquid--exercises requisite for working into financial shape. Ergo, when the tax cut comes this year they should be a little freer with the dollar than they were last year.

Which is not to say consumers will go on a buying binge. For one thing, the unemployment rate will remain high, and fear of unemployment will doubtless still work to hinder spending. For another thing, personal income growth will likely be fairly slow as recession-wracked companies rehire workers only cautiously and grant wage hikes only grudgingly. Thus while consumers should lend the '83 recovery a helping hand, that hand may be a little shaky--one reason why a 5% surge in growth this year does not seem the most probable outcome.

Housing: Bubble or Breakthrough?

Another reason not to expect a roaring recovery in 1983 is housing. Yes, housing starts shot up a startling 35% in January to 1.7 million units at an annual rate. And yes, residential investment will probably be the fastest-growing major sector of the economy this year. But that 1.7 million figure looks suspiciously liable to statistical aberration. And even if housing starts jump 30%-35% as forecast, 1983 will still be a sub-par year for the housing industry.

Moreover, a 30%-35% jump will still leave lots of latent demand for housing unsatisfied because the great majority of Americans will remain financially unable to carry a mortgage at the going rate. That rate, about 13%, is down considerably from a year ago, yet it closes two-thirds of American households out of the market (see Chart III). To spur a robust rally in housing, rates would have to drop several more points--an event that hardly seems likely.

One big stumbling block to lower mortgage rates is the high cost of funds to savings and loan associations. Even before the new bank

Chart III. Even 13% Mortgage Rates Leave Majority Out of Market

Mortgage Rate (%)	Income Required to Carry $60,000, Mortgage*	% of U.S. Households Priced Out of Market for Average Housing**
9%	$23,000	55%
11	27,000	65
13	31,000	70
15	35,000	80

*Assumes annual real estate taxes of $1,500 and interest payments plus taxes at 30% of income.

**Percentages rounded to indicate roughness of estimate.

money market accounts were authorized, S&Ls' cost of funds averaged 10%-11%. With the huge inflow of funds to these new high-yield accounts, S&Ls' cost of funds will probably rise further, quashing any move to lower mortgage rates.

Lofty Interest Rates Will Stay Aloft

Of course, if interest rates in general declined then the cost of funds to S&Ls would decline and competition would force banks to lower mortgage rates. But for rates to come down much more would require at least two pieces of good luck: 1) The Federal Reserve Board would have to supply sufficient reserves to finance the recovery without appearing to open the monetary floodgates, thereby raising fears of inflation. 2) The Congress and the President would have to agree on spending cuts/tax hikes so that the specter of a government monster gobbling up the country's future savings could be exorcized.

The economy may be luckier with the Fed this year than with the deficit. Since July, the Fed has managed to rev the money supply and push interest rates down without exacerbating inflation. The rate

decline was also due, importantly, to a sharp drop in business loan demand as companies slashed inventories and capital expenditures.

In part, too, the Fed's success might stem from confusion about definitions of the money supply resulting from maturation of all-saver's certificates and introduction of new types of bank accounts. That confusion, which persists, makes it unclear whether the Fed has really gunned the money motor too hard. So with inflation under wraps for the moment (especially now with oil prices dropping) and with some policy measures showing the Fed still in control, monetary policy may not be exerting any upward pressure on interest rates. Until the technical fog lifts, however, investors may be standing pat, refusing to accept a return much lower than that currently obtainable.

The deficit's impact on rates, however, is less ambiguous. It's true that rates tumbled last year even though it was known that government deficits would be very large. But during this period the money supply was surging and loan demand was crumbling. What's more, last August the Congress enacted a new tax law aimed at reducing deficits by $100 billion over three years, perhaps raising hope in financial markets that the government intended to tackle its deficit.

While rates were falling, big budget deficits of $100-$150 billion were envisioned through mid-decade. That gap soon widened into a chasm, however. And when projected deficits started mushrooming to $200 billion, the interest rate drop came to a stop, high-quality corporate bonds getting stuck at about 12% and 3-month Treasury bills at about 8% for the past several months. This at a time when the inflation rate was declining to 4%-5%.

Despite this large gap between interest rates and inflation, and despite continued weakness in business borrowing, rates are not forecast to move down much more, if at all. For just as in recent months, fears of huge government borrowing are expected to keep persistent upward pressure on rates.

(International pressures, too, could keep rates up: If a major country like Mexico defaults, U.S. banks could react by raising rates to other borrowers. If, on the other hand, the U.S. helps bail out debtor nations, then increased borrowing--like the proposed $8 billion for the International Monetary Fund--could nudge rates up.)

To finance its deficits, the government will stake claim to one-quarter to one-third of private saving in the next several years. That's uprecedented in the post-World War II era, as shown in Chart IV.

Because it's unprecedented, the impact on private investment and on the economy as a whole is unknown. At the minimum, though, it seems the deficits will create enough uncertainty in financial markets to keep interest rates well above the rate of inflation. The upshot: Unless government acts to pare its deficits, the economy will remain shackled.

Rates Batter Exports, Capital Spending

Continued high interest rates will not only restrain [illegible]y in housing and autos, they will also make it difficult for exports and business capital investment to make any gains at all through the year. High rates keep the dollar strong, which hurts exports; at the same time, high rates make external financing an unattractive alternative for

Chart IV. The Reagan Deficits Will Eat Up Too Much Private Saving

	$ Billions			
	Personal and Business Saving	U.S. Government Deficit	Deficit as % of Saving	Comments
1953	$56.7	$7.1	12.5%	1953-54
1954	58.1	6.0	10.3	recession
1958	75.3	10.3	13.7	1957-58 recession
1967	139.9	13.2	9.4	Late-1966 credit crunch, Vietnam
1970	158.6	12.4	7.8	1969-70
1971	180.3	22.0	12.2	recession
1975	282.7	69.3	24.5	1974-75
1976	294.4	53.1	18.0	recession
1977	326.9	45.9	14.0	Growth in gov't
1978	374.0	29.5	7.9	transfers to
1979	407.3	16.1	4.0	persons
1980	438.3	61.4	14.0	Recession
1981	504.7	28.2	5.6	Recession, Reagan
1982	529.9	116.1	21.9	program
Projected				
1983	575	200	35	
1984	665	200	30	
1985	745	190	25	

raising investment funds. Thus while gross national product adjusted for inflation is expected to rise about 4% from 1982's fourth quarter to this year's fourth quarter, both real capital investment and real exports are projected to be down.

Interest rates don't deserve all the blame, however, for declines in exports and in new plant and equipment spending. The former will also

be battered by continued softness of overseas markets. Data Resources, Inc., for example, forecasts that Western Europe's 1983 industrial output, while picking up during the year, will still fall below the level of 1982. Meanwhile, debt-laden developing countries may try to constrict imports to conserve precious foreign exchange.

Back home, U.S. capital spending will continue to feel the effects of the 1981-82(?) recession in 1983. Basic industry, in particular, has every reason this year to put off new plant and equipment purchases. Industries like steel, machinery, and chemicals, for example, are sitting on top of a huge amount of excess capacity, while simultaneously they are financially strapped.

Another big negative in capital investment this year will probably come in the form of sharply reduced oil exploration. With crude prices trembling on the verge of a possibly steep fall, oil drillers are likely to hold off before committing big dollars to projects that could turn into big losers. Inflation-adjusted outlays for oil drilling could easily plummet 20% this year, the final figure depending on developments within OPEC and in the international petroleum.

Summary

Recovery should finally get underway in 1983. The first shot to growth will come via inventories and housing in the first quarter of the year.

For the year as a whole, consumer spending--especially spending on durables such as autos and appliances--is expected to play a key role in sustaining growth. The July 1 tax cut will be a boon to consumers, but other conditions that weren't around last year will also help. Namely,

interest rates and debt burdens will be lower; the stock market and savings will be higher; and mirabile dictu, oil prices could be sharply lower.

Even if inventories, housing, and consumer spending do kick off and sustain a recovery, though, U.S. exports and capital expenditures will likely tumble after adjusting for inflation. In part, both of these important sectors will suffer from continued high interest rates. For even though business loan demand will be weak for some time, and even though inflation is expected in the 4% range throughout the year, interest rates are expected to stay at lofty levels. The main reason: Big government deficits.

Because of high "real" interest rates, then, the forecast looks for economic growth this year of only a little better than 2%--not good by historical standards for a recovery year. If this forecast materializes, however, at least the economy would be pointed upward. At the same time, a foot-dragging recovery might convince Washington that something decisive must be done to bring government spending and government revenues more into line with each other.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

National Product Accounts	-Actual- 1982 4Q	Forecast 1983 1Q	1983 2Q	1983 3Q	1983 4Q	1984 1Q	Annual 1981	Annual 1982	Annual 1983
Gross National Product	3101.4	3163	3214	3271	3353	3427	2937.7	3057.6	3250.3
Consumer Spending	2031.5	2054	2087	2127	2182	2222	1843.2	1971.3	2112.5
Durables	251.2	253	258	263	272	276	234.6	242.5	261.5
Nondurables	775.3	777	781	791	810	822	734.5	762.0	789.8
Services	1005.0	1024	1048	1073	1100	1124	874.1	966.8	1061.3
Nonresidential	336.9	332	330	331	333	336	346.1	347.6	331.5
Structures	139.2	137	136	136	135	134	129.7	141.4	136.0
Producers Durable Equipment	197.7	195	194	195	198	202	216.4	206.2	195.5
Residential	99.8	116	122	125	129	134	104.9	95.8	123.0
Inventory Change	-44.2	-10	0	7	12	20	20.5	-22.8	2.3
Federal Government	276.1	273	279	285	294	300	228.9	257.7	282.8
Defense	188.9	194	199	204	211	216	153.7	178.6	202.0
Nondefense	87.2	79	80	81	83	84	75.2	79.1	80.8
State & Local	399.6	404	407	414	422	430	368.0	389.6	411.8
Net Exports	0.8	-6	-11	-18	-19	-15	26.1	18.5	-13.5
Real GNP (1972 Dollars)	1473.9	1489.1	1499.1	1509.5	1530.3	1545.1	1502.5	1476.0	1507.0
(% change at annual rate)	-1.9	4.2	2.7	2.8	5.6	3.9	1.9	-1.8	2.1
Implicit Price Deflator	210.42	212.41	214.40	216.69	219.11	221.80	195.51	207.23	215.69
(% change at annual rate)	3.7	3.8	3.8	4.4	4.5	5.0	9.4	6.0	4.1
Key Economic Indicators & Assumptions									
Unemployment Rate (%)	10.7	10.6	10.3	10.1	9.7	9.1	7.6	9.7	10.2
Housing Starts (thousands of units)	1250	1430	1375	1400	1450	1490	1084	1059	1414
Consumer Price Index (% change at annual rate)	2.6	1.0	4.0	5.5	5.5	5.8	10.3	6.1	3.7
90-Day Treasury Bill Rate (%)	7.9	8.1	7.6	7.8	8.3	8.5	14.0	10.6	8.0
Corporate Bond Yield (%)	11.9	11.7	11.5	11.3	11.5	11.7	14.2	13.8	11.5
Personal Income ($ Billions, SAAR)	2623.2	2657	2701	2754	2799	2843	2415.8	2570.6	2727.8
Disposable Personal Income ($ Billions, SAAR)	2223.5	2257	2291	2361	2393	2431	2029.1	2173.4	2325.5
Saving as % of Disposable Income	5.8	6.1	6.4	7.4	6.3	6.1	6.4	6.6	6.7

SAAR-Seasonally Adjusted Annual Rate

C5802 - 11A 6/13/83

Economics Department

McGraw-Hill Publications Company
1221 Avenue of the Americas
New York, New York 10020

May, 1983

U.S. BUSINESS OUTLOOK SHORT-TERM

Along with plenty of rainfall, April also brought with it plenty of nourishment for the economy. Most spectacularly, both retail sales and industrial production spurted some 2%, the best performance in years.

This shower of good news points to an economic flowering in the second quarter, when inflation-adjusted gross national product (GNP) is forecast to jump nearly 6% at an annual rate. The economy hasn't grown that much since the January-March period of 1981. Problem is, it may again be a long time before the economy can muster such strength.

For the short-term spike in GNP will depend heavily on a big inventory swing. After producers have turned their inventories around, however, the economy will again be looking for some major engine of growth. Potentially the most powerful engine is consumer spending, and consumers in fact are expected to rev up their purchases. But at the same time, mammoth budget deficits and a hamstrung monetary policy will keep interest rates on their lofty perches. And by next year these persistently high interest rates could slow the momentum the economy will be building in 1983.

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Inventories Instigate Growth

In 1983's first quarter--also the first quarter of recovery--inventories played an important supporting role. In the second quarter, inventories should move center stage.

As Chart I shows, business slashed stocks of goods and materials in 1982's fourth quarter, and then continued to whack away in 1983's

Chart I. It's Time to Restock

		Inventory Change (1972 $)	Inventory/Sales Ratio	Economic Growth (%)*
1982	I	-15.4	1.52	-5.1
	II	-4.4	1.51	2.1
	III	3.4	1.52	0.7
	IV	-20.3	1.53	-1.0
1983	I	-16.1	1.48	2.5

*Percent change at annual rate of GNP in 1972 dollars.

first quarter. The blow fell a bit more softly in the first quarter, however, which meant that companies had to produce more to make sales. In this way the small inventory "gain" (up from -$20.3 billion to -$16.1 billion) helped the economy grow in the first quarter.

Business' recent record efforts to cut stocks also pushed the inventory/sales ratio down to its lowest level in nearly two years. Given that sales and production have shot up so strongly, this falling ratio could signal that inventories are at the point where shortages of product could hurt companies' marketing efforts. It thus seems about time for managers to rebuild their stocks.

However, because interest rates are still high, extreme caution may continue to rule inventory decisions until markets firm up some

more. For example, despite sales surges in March and April, inflation-adjusted retail sales in the whole first quarter dipped from 1982's fourth quarter. Manufacturers may be feeling more encouraged than retailers right now, with production up at a strong 9.5% annual rate in the first quarter. Nonetheless, production has only just begun to surpass year-ago levels.

In short, inventory building in the coming months could be less than exuberant because industry has been battered by three years of no growth. During the same period, too, companies have relied increasingly on computers to aid decision-making, and thus should be able to keep tighter control of stockpiles.

Hence inventories are expected to grow only slowly in the near term. Even so, that would be a big change from the record cuts of the previous half year, with the result that GNP should be getting a hefty boost.

The Housing Spark Sputters

The capacity of inventories to spur sustained economic growth is, of course, limited. Inventory building can serve as kindling, but there has to be something more substantive around to get up a blaze.

For about half a year, the substantive fuel has been residential construction. Since hitting bottom in June of 1982, housing starts have skyrocketed (see Chart II), making residential investment the fastest growing sector of the economy. In fact, if housing were excluded from GNP, the economy in the first quarter would have grown only 0.6% (annualized) rather than 2.5% as it did.

The discrepancy between 0.6% and 2.5% is large and it could be ominous. For as Chart II shows, the housing front has started to crack,

Chart II. Housing Hunkers Down

	Housing Starts (Millions, SAAR)	Mortgage Rate %
1979 (Annual)	1.75	11.3%
1982 Jan.	.88	17.3
Feb.	.91	17.5
March	.92	17.5
April	.91	17.4
May	1.03	17.3
June	.91	17.2
July	1.19	17.2
Aug.	1.05	17.0
Sept.	1.13	16.2
Oct.	1.14	15.6
Nov.	1.36	14.6
Dec.	1.28	14.2
1983 Jan.	1.69	13.9
Feb.	1.78	13.6
March	1.63	13.3
April	1.49	13.1

SAAR - Seasonally adjusted annual rate.
NA - Not applicable or not available.

with starts falling in both March and April. Which is not surprising, given that February's surge seemed clearly unsustainable in the face of 13+% mortgage rates. Note, for example, that in 1979--housing's last good year--mortgage rates averaged two percentage points below today's rate. Thus if mortgage rates stay at about 13%, it would probably be tough for housing starts to get past 1.5-1.6 million this year, a little less than the rate they've been running through the first four months of the year. The implication: The housing comeback has crested. The

further implication: Something must replace housing as the primary engine of recovery.

Recovery Needs the Consumer

That something has got to be the consumer. In sharp contrast to their doling out of dollars in the 1975-79 economic expansion, consumers since 1979 have pinched pennies. The time now seems right for consumer behavior to change again--not to revert to the spend-before-prices-rise psychology of 1975-79, but at least away from the wolf-at-the-door fears of 1979-82.

For the parsimonious consumer of the past few years has produced at least two positive outcomes: 1) the dramatic cooling off of inflation, 2) the rebuilding of consumer balance sheets--a rise in assets and a paring of debt relative to income. Put these two together and you've got the makings of increasing consumer confidence, increased willingness to take on new debt, and increased spending.

Consumer spending should also be buoyed by the beginnings of an upturn in employment (see Chart III) which is giving rise to healthy growth in personal income. In addition, income growth should get a near-term boost from tax refunds that got paid out late this year as people scrambled right up to April 15 to open IRAs.

And then there's the stock market boom that has, at least on paper, sharply increased some people's wealth. Economists figure that over time some 5%-6% of this increase in wealth makes its way into purchases of new cars, appliances, and other consumer goods. Whatever the exact relationship between the stock market and consumer spending, a

Chart III. The Consumer Gains Strength

	Non-Farm Employment (Millions)	Disposable Personal Income (% Change from Previous Month)	Debt Burden*	Consumer Confidence Index
1982 Jan.	90.5	0.3	15.6	71.0
Feb.	90.5	0.4	15.5	66.5
March	90.3	0.3	15.5	62.0
April	90.1	1.0	15.4	65.5
1983 Jan.	88.9	0.5	15.2	70.4
Feb.	88.8	-0.1	15.3	74.6
March	89.0	0.6	15.3	80.8
April	89.2	1.0	NA	89.1

*Consumer credit as percent of disposable income.

50% surge in stock prices has got to turn up to some extent in showrooms, stores, travel agencies, and restaurants. In fact, recent evidence suggests that the consumer is already back, and in a big way. Sales at the nation's retail stores leaped 1.7% in March, followed by another 1.6% in April. In line with the earlier jump in housing, sales of appliances, furniture, and other household durables have been particulary strong.

Unfortunately, however, all is not sweetness and light with the consumer. For while the stock market, consumer confidence, personal income, and employment are up, the rate of unemployment remains extremely high at around 10%. Moreover, because the unemployment rate tends to decline sluggishly in the early stages of recovery, it will likely stay in the 9+% range for a year or so.

The threat to the recovery implicit in such a high number is that many employed people will take it as a signal that job security is

touch-and-go. The natural reaction, then, is to keep a close watch on expenditures.

High unemployment notwithstanding, though, the pace of consumer spending is expected to quicken, especially in the latter part of the year after the final round of the Reagan personal tax cuts has gone to work. Another possible fillip in consumption could occur in the summer and fall. That's when people who got in on the early stages of the bull market might sell their stocks to realize a long-term capital gain, the holding period for which is one year. All told, the forecast calls for consumer spending after inflation to rise about 4% in 1983.

Interest Rates Remain a Damocles Sword

If the recovery in consumer spending and the recovery in the economy in general does not proceed, the fault will lie with high interest rates. High rates have locked automobile sales into second gear; they've kept housing starts well below where they could be; they've kept the U.S. dollar exceedingly strong, hence exports weak; and they've given companies one more reason to put off investing in new plant and equipment.

In short, for several years high rates have crimped the economy and now they threaten to short-circuit the recovery. This high-rate refrain, with the devastating deficits as counterpoint, has long ago become tiresome. Yet the politicians refuse to take enough decisive action to slash those deficits.

True, Congress did finally accept a Social Security package that should prevent the retirement trust fund from hemorrhaging. But the faster-growing Medicare segment of Social Security has yet to be put

under the knife. At the same time, military spending gets criticized yet the defense budget continues to explode. In general, the politicians are giving short shrift to proposals for cutting the deficit on the spending side.

Not much is happening on the revenue side either. The biggest chunk of government revenue could be "saved" by repealing tax indexation scheduled for 1985. Yet if indexation were eliminated, it would hurt lower and middle-income people most, since the tax brackets are closer together at the lower end of the income scale. A more philosophical objection to repeal is that without indexation the government can silently appropriate larger and larger shares of the nation's income as inflation pushes people into higher tax brackets. For this same reason, however, Congress may find it attractive to axe indexation. Meanwhile, though, no decision seems imminent.

Politicians unmoved by tidal waves of red ink say that even with the prospect of $200 billion deficits interest rates have fallen and recovery has gotten underway. Such reasoning, however, seems perverse.

It's true, of course, that interest rates have fallen since last summer. But why? Not because financial markets suddenly felt that deficits don't matter. But because the economy had become weak enough to depress private sector demand for funds and because during the same period the money supply rocketed. Thus on a [illegible]and-supply basis alone interest rates should have plunged.

Add in the facts that inflation in general is abating, and oil prices in particular actually tumbled, and the conclusion is that interest rates should be on the floor. High-quality corporate bonds, for example, should not be above the 9% they were at the start of the

1975 expansion when inflation was twice what it is now. Yet bonds are now yielding 12%.

Thus those who claim deficits aren't so important should explain why rates aren't far lower.

More recently, the burden of explaining interest rates has become even heavier. For while the decline in rates has spurred a recovery, the recovery appears sub-par. To get more growth, a further drop in rates is required. Yet of late rates have edged back up. This in spite of the fact that corporate cash flow is improving, that inventory building has not begun or is as yet only modest, and that capital spending is still stagnant.

Such financial developments are typical of the early part of an economic recovery and they explain why interest rates typically stay flat--or even decline a bit--for a long time into an expansion. In the 1975 expansion, for example, rates didn't turn up until 1978.

This time around the story seems different. The difference is not a large recession-caused deficit (deficits in 1975 and 1976 were big). The difference rather is the firm expectation that future deficits will be so immense and so persistent that they will put permanent pressure on the money markets, or that the government will have to finance them through excessive money creation. Either alternative points to continuously high interest rates, thus to continued economic sluggishness in the long run.

If nothing else, these immense projected deficits probably generate much uncertainty. Hence investors who got burned in the 1970s will continue to tack substantial risk premiums onto their required rates of return. At the same time, whatever the Federal Reserve does in

the face of these deficits can be interpreted negatively: If the Fed raises money growth, it looks like they're monetizing the deficit and spurring inflation; if the Fed tightens, it looks like they're choking off funds needed to finance recovery.

Yet because consumers are in good financial shape, because inventories need beefing up, and because the pickup of housing construction will carry through into coming months, the recovery is forecast to continue even in the face of threateningly high interest rates. But the promise of a sustained recovery through 1984 is by no means assured. Fueled by business' move to restock and to replace worn-out plant and equipment, a renewed rise in rates could abort the recovery next year. What the economy sorely needs is a reprieve from this high-interest-rate regime, a reprieve that can only come from Washington.

Summary

The second quarter of 1983 looks like a winner. Retail sales and industrial production are spurting. And since companies slashed inventories in the past half year, they should soon start to rebuild. Once they do, even if only slowly, that will add strength to the recovery.

Hope for a sustained recovery, however, is pinned on consumer spending. With employment heading up, with personal income growing, and with debt burdens easing, consumer confidence is on the rise. More help is on the way, too, in the form of the third round of the tax cut. Thus, despite the high unemployment rate, consumer spending should help sustain the recovery through 1983.

Beyond this year, however, the recovery is threatened by high and rising interest rates. Already, high rates have begun to erode the housing recovery. High rates will also put a damper on the inventory buildup; they will help thwart capital spending; and they will keep the dollar overly strong. In short, high interest rates could make the recovery a short one.

The major stumbling block to lower interest rates appears to be the gargantuan federal deficits--both present and projected. The government's thirst for funds will either maintain continued pressure on financial markets; or it will lead to monetization of the debt, hence more inflation. The solution would be to cut federal spending and raise taxes. To date, however, Washington seems fearful of doing either, and would rather see how the recovery does or doesn't proceed.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars, SAAR)

National Product Accounts	-Actual- 1983 1Q	Forecast 1983 2Q	1983 3Q	1983 4Q	1984 1Q	1984 2Q	Annual 1981	Annual 1982	Annual 1983
Gross National Product	3170.9	3259	3313	3385	3462	3550	2937.7	3059.3	3282.0
Consumer Spending	2054.2	2097	2139	2186	2234	2280	1843.2	1971.1	2119.1
Durables	257.3	264	272	279	283	287	234.6	242.7	268.1
Nondurables	776.8	788	797	813	830	849	734.5	762.1	793.7
Services	1020.0	1045	1070	1094	1121	1144	874.1	966.3	1057.3
Fixed Investment	458.6	463	466	476	490	504	451.0	444.1	465.9
Nonresidential	338.1	337	340	346	354	364	346.3	348.0	340.3
Structures	137.4	136	135	136	137	139	129.7	141.5	136.1
Producers Durable Equipment	200.7	201	205	210	217	225	216.4	206.5	204.2
Residential	120.5	126	126	130	136	140	104.9	96.2	125.6
Inventory Change	-37.3	-2	4	9	12	18	20.5	-23.8	-6.6
Government Purchases	676.4	687	698	719	728	744	596.9	647.4	695.1
Federal	274.0	280	286	300	301	309	228.9	257.9	285.0
Defense	192.9	199	204	214	218	225	153.7	178.6	202.5
Nondefense	81.1	81	82	86	83	84	75.2	79.3	82.5
State & Local	402.5	407	412	419	427	435	368.0	389.4	410.1
Net Exports	19.0	14	6	-5	-2	4	26.1	20.5	8.5
Real GNP (1972 Dollars)	1486.2	1506.6	1520.8	1539.6	1557.0	1575.2	1502.5	1476.9	1513.3
(% change at annual rate)	2.5	5.6	3.8	5.0	4.6	4.8	1.9	-1.7	2.5
Implicit Price Deflator	213.30	216.31	217.85	219.86	222.35	225.37	195.51	207.14	216.85
(% change at annual rate)	5.6	5.8	2.9	3.7	4.6	5.5	9.4	5.9	4.7
Key Economic Indicators & Assumptions									
Unemployment Rate (%)	10.2	10.0	9.7	9.3	9.0	8.8	7.6	9.5	9.8
Housing Starts (thousands of units)	1702	1455	1475	1550	1600	1600	1084	1059	1546
Consumer Price Index (% change at annual rate)	-0.4	3.6	4.4	4.6	4.9	4.7	10.3	6.2	3.0
90-Day Treasury Bill Rate (%)	8.1	8.3	8.6	9.0	9.5	10.0	14.0	10.6	8.5
Corporate Bond Yield (%)	11.8	11.6	11.6	12.0	12.5	13.0	14.2	13.8	11.8
Personal Income ($ Billions, SAAR)	2648.2	2695	2749	2806	2866	2921	2415.8	2569.9	2724.6
Disposable Personal Income ($ Billions, SAAR)	2247.2	2290	2361	2408	2458	2503	2029.1	2172.7	2326.6
Saving as % of Disposable Income	5.9	5.8	6.9	6.7	6.6	6.4	6.4	6.5	6.3

SAAR-Seasonally Adjusted Annual Rate